

CABINSITE APPRAISAL LEASE RATE CALCULATION ALTERNATIVES PRESENTATION

September 21, 2009
Land Board

The DNRC will give an informational (non-action item) presentation on the cabinsite lease rate calculation alternatives to the Land Board. For further information relating to the proposed alternatives, visit the DNRC's website at <http://dnrc.mt.gov/cabinsite/LeaseFeeFAQ.asp>.

The Montana Department of Natural Resources (DNRC) administers 764 sites are considered “active” cabin site leases statewide.

The latest Department of Revenue (DOR) statewide property reappraisals requires the review of the land values of those cabin site leases, and by extension the cabin site lease fees, as the DNRC uses the DOR appraisal values as the basis for calculating lease fees.

Awareness of the current DOR appraisal cycle, coupled with the belief that the DOR appraisal did not capture the recent economic downturn, dissatisfaction with DNRC’s use of 100% of that DOR value, and knowledge that lease fees would be increasing for all lessees over time, caused residential lessees to voice their concerns.

The DNRC began investigating what changes to the lease fee process would entail, how lessee concerns might be addressed, and what changes would mean to projected revenues.

The DNRC held public meetings in Seeley Lake and Kalispell in late June 2009 and collected comments from cabin site lessees on the current lease fee methodology and factors that might be addressed to improve the lease fee calculation methodology.

The comments received at the June public meetings were summarized into the following areas: lease fee predictability; lending stability; lease term; appraised value of leased land; full market value to beneficiaries; fairness to our lessees; having all leases/lessee pay on the same base value in the same year; and flexible sublease policy.

After reviewing comments and suggestions the DNRC developed five different alternatives, which are being presented to the Land Board at this September 21, 2009 meeting.

A letter was sent to all cabin site lessees with a description of all five alternatives, a projection of lessee lease fees under the different alternatives, reference to complete cabin site analysis information on a DNRC web page specifically made for the cabin site lease analysis, and an invitation to comment to the DNRC on the alternatives through the month of September 2009.

Included in this Land Board package is an executive summary of a cabin site lease report developed by the DNRC. The executive summary includes a brief description of all five alternatives for changes to the lease fee calculation process.

**Analysis of Lease Rent Calculation Alternatives for
Cabinsites on Montana's State Trust Lands**

**STATE OF MONTANA
DEPARTMENT OF NATURAL RESOURCES
AND CONSERVATION**

September 2009

EXECUTIVE SUMMARY

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This report provides an overview of the residential leasing program on Montana school trust lands, and analyzes four alternatives for calculating the lease rents for cabin and homesite leases. A fifth alternative, Negotiated Rulemaking, is also discussed.

The Montana Department of Natural Resources (DNRC) administers 802 cabinsites and homesites across the state. Currently 764 sites are considered “active” leases. The following table shows the FY09 cabin and homesite revenue generated by each Trust.

Trust	Leases	FY09 Revenue
Common Schools	319	\$438,335
MSU 2nd Grant	195	\$501,472
MSU Morrill	2	\$4,839
Public Buildings	55	\$40,132
Deaf and Blind School	37	\$27,360
School of Mines	107	\$461,873
Veterans Home	1	\$973
State Industrial School	35	\$72,517
State Normal School	12	\$22,297
U of M	1	\$2,230
TOTAL	764	\$1,572,028

Prior to 1983, the state charged nominal annual lease rents. Recognizing that the state was not obtaining full market return for cabinsites, the 1983 State Legislature set the lease rent at 5% of the “lease value” of a cabinsite. In 1989 the Legislature directed the DNRC to use the appraised value of cabinsites as determined by the Department of Revenue (DOR) through their periodic revaluation of property and set the lease rate at 3.5%.

With passage of SB424 by the 1993 Legislature, which directed the Land Board to establish all rates and rents for surface uses, the Land Board established an advisory council to review current lease rates. Upon the recommendation of the advisory council the Land Board maintained the lease rate at 3.5%.

In 1999, in *Montanans for Responsible Use of the School Trust v. State of Montana* (the MonTrust case), the Supreme Court ruled in favor of MonTrust and concluded that the lease rate of 3.5% in rule at the time “violates the trust’s requirement that full market value be obtained...”. As a result of the MonTrust case, the Land Board directed the DNRC to establish a negotiated rulemaking committee to establish fair market rate for cabinsite leases. The committee’s recommendations were approved by the Land Board and adopted in January 2001. The amendments increased the cabinsite lease rate to 5% of the DOR appraisal value, to be phased in over five years, and addressed how lessees would be compensated for their improvements by a new lessee at the time of assignment.

As required by 77-1-208, Montana Code Annotated (MCA), DNRC uses the DOR regular appraisal values as the basis for calculating lease rents for cabinsite leases. Leases are about half-way through the process of completing a phase-in which, when complete between 2009 and 2013, will bring all cabinsite leases from a lease rent amount of 3.5% of the 1997 DOR value to 5% of the 2003 DOR value.

With release of the 2009 DOR preliminary appraised values in early 2009, it became clear to many lessees that their lease payments would increase significantly over the next several years. In general, current discussion of revising the policy for calculating rents is driven by concerns raised by lessees that new rents, based on the preliminary 2009 appraised values, are too high for

some cabinsite lessees to pay. Other common arguments include: 1) lease rents are too unpredictable for lessees to predict the future cost of owning a lease; 2) lease durations are insufficient for lessees to obtain long-term financing; 3) DOR appraised values are unrealistic and do not recognize the “bursting” of the real estate bubble or the present economic downturn; and 4) if no change to current lease structure is made, many cabin and homesites will end up vacant and residential lease revenues will decline significantly.

FINDINGS

- Lease rents have gone up considerably over the past two appraisal cycles. This has led to unpredictable lease rents for cabin and homesite lessees, particularly in the high amenity, high value areas of the state.
- Most lending institutions that provide long-term financing for home construction on leased land require a minimum lease term greater than the expected mortgage term; a few require significantly longer lease terms. Cabin and homesite leases are issued for a 15-year term. A 15-year lease may not be long enough for some lessees to obtain long-term financing. Administrative Rules of Montana currently allow for a 25-year lease term for lending purposes.
- The DOR conducts a statewide appraisal of property every six years, the last being in 2009. In an effort to assess the DOR appraisal values in question, the DNRC evaluated and compared the historic rate of appreciation for state cabin and homesite leases to other sources of land appreciation data. DOR data were compared to data from three different sources; the long-term (20 to 30 years approximately) annual rates of appreciation suggested by these other sources ranges from 6.14% to 6.6%. This would reflect an average rate of appreciation over six years (corresponding to the six year DOR appraisal cycle) somewhere in the range of 42.9% to 46.7%.

The average change in DOR appraised value from 2003 to 2009 for the state’s cabinsite lease sites is 130%. The majority of the cabinsites, 619 sites, which is 81% of all cabinsites, saw an increase of 0% to 200%. A few cabinsites saw appraised values go down between 2003 and 2009. The two sites with the highest rate of increase, at 1142.5% and 1350%, are both in Eastern Montana.

- It is quite possible that new vacancies will occur as some lessees reach the upper limit of their ability to afford the lease rents for their cabinsite and homesite lease. There is no model which currently shows a solid relationship between rents and vacancies, nor demonstrates any cause and effect therein.

This report concludes that, if rents are set at 5% of the 2009 DOR values, then the top 144 most expensive leases (18.8% of the active leases) must go vacant to reduce total annual revenue below what would be expected if rents remained at 5% of the 2003 DOR value with no additional vacancies. Again, this estimate assumes that only the highest-valued cabinsites (cabinsites with the highest lease rents) are vacated.

- An examination of the private market was conducted to analyze lease rates for similar
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properties. Interviews of appraisers, other state agencies and research of historic Treasury notes were conducted. Lease rates range from 5% to 13% among the various respondents.

- Staff completed a survey of mobile home lots, recreational vehicle sites and cabins from Kalispell and Seeley Lake. Minimal amenities, if any, are provided and these rents could be considered comparable to some of the state lease sites in the area used for primary residences having nominal recreational attributes. Cabin rentals from Kalispell to Seeley Lake, both on and by water, were also noted. Rents run from \$270 to \$1,950 per week, varying by whether they are located on water or not, the amenities included and time of year.
- Staff completed a study of non-family transfers to ascertain if leasehold values were being realized by the lessees. Leasehold value is the value in property that is realized by a lessee when the lessee receives more than the value of their improvements at sale/assignment. If a lessee pays market rent, then the leasehold would theoretically have no value. However, if the lessee pays less than market rent, the difference between the present value of the market rent for a lease site and the present value of the rent actually being paid would create leasehold value for the lessee.

A review was made of all 30 assignments in the Seeley Lake area between August 2003 and May 2009 and all 26 assignments in the greater Kalispell area made between November 2004 and July 2009. Sales prices and closing dates were compiled along with the 2009 DOR appraised values of improvements. This information is included in Appendix E. Certain interpolation of improvements values relative to sale dates and dates of valuation were required. In 44 of the 56 sales lessees realized leasehold value at the time of assignment.

- This report suggests a policy allowing for a rent freeze for low-income cabin and homesite lessees for up to three years. Repayment of any deferred rent would be required.
- This report also suggests modifications to the improvements management policy. Recommended are three specific policy changes:
 - a) The time provided to lessees for the sale of improvements should be extended from two years to 3-4 years to provide time necessary for successful marketing and release of the property.
 - b) The value of improvements may need to be calculated by a more formulaic process. For example, the value of improvements may be determined using the DOR's assessed value for improvements, or by requiring the lessee to hire an independent, qualified appraiser to value the improvements (using a DNRC-approved scope of work for the appraisal).
 - c) The DNRC could offer a Maintenance and Marketing LUL, which would permit the lessee to maintain the improvements and provide for successful marketing and release of the property.

LEASE POLICY ALTERNATIVES

This report presents four developed alternatives for lease rent calculation. Each alternative is evaluated according to 12 criteria. An additional alternative includes negotiated rule-making.

The alternatives are discussed briefly below. A comparison of the key components of each alternative, and how each meets the 12 evaluation criteria, is provided in the following table.

Alternative 1: Current Policy – This refers to the rent calculation methods currently in place.

Alternative 2: 2009 Phase-in Set Growth – The lease rate is set at 3.6% of the 2009 DOR value, phased in over five years, and then escalated at a set annual rate of 6.5%.

Alternative 3: 2003 Set Growth – Uses “Projected 2009 DOR value” which is the 2003 DOR value projected to 2009 at 6.5% annually. Lease rate starts at 5% and escalates at 6.5% annually.

Alternative 4: Joint Venture – Recommends freezing lease fees for one year to conduct a study, as well as market and lease rate analyses. The study would include representatives from all stakeholder groups to further develop the concepts and/or other strategies that may come to light during the study. The analyses would utilize Statement of Financial Standards No. 157 for developing fair value measurements to establish affordable and stable annual lease rates, and combine the annual lease payment with leasehold value appreciation payments (upon assignment or sale). At the conclusion of the study period (September 2010), the committee would propose a fully developed and vetted alternative for the Land Board to take to rulemaking. The lease fee numbers presented in this analysis are for demonstration purposes only. The exact lease rate, indices, leasehold value, and other contributing factors are yet to be determined. The demonstration analysis uses the 2003 DOR appraised value as the base value, with the lease rate set to the Consumer Price Index, which typically ranges from 3.6% to 5%; and, at sale/assignment, estimates that 50% of the land appraisal represents a leasehold value, with seventy percent of that leasehold value being paid to the State.

Alternative 5: Negotiated Rulemaking – A negotiated rule making committee (2-5-101, MCA) would be formed of DNRC personnel, lessees, Trust Beneficiaries and other interested parties. With an arbitrator, the committee would make a new alternative and recommend the concept be developed into administrative rules and implemented as the new lease policy.

KEY COMPONENTS	Alternative 1: Current Policy	Alternative 2: 2009 Phase-in Set Growth	Alternative 3: 2003 Set Growth	Alternative 4: Joint Venture
Estimated Revenue over 30 years	\$218,287,424	\$171,549,776	\$222,954,540	\$120,495,840
Predicted Vacancy Rates	3%-10%	3%-8%	3%-8%	~0%
Appraisal Source	DOR (2009 value)	DOR (2009 value)	DOR (2003 value projected to 2009 at 6.5% annually)	DOR (2003 value)
% of Appraisal Value Used	100%	100%	100%	100%
Lease Rate	5%	3.6%	5%	Variable; 3.6% to 5%
Phase-In	Yes	Yes	No	No
Annual Escalator	No	6.5%	6.5%	No
Cap	No	15% above/below 2025 rent, max cap 50% increase; 65% above/below max cap, escalate yearly	Same as Alternative 2	Yes; rate limited to between 3.6% and 5%
Term	15 years	Up to 50 years	Up to 50 years	Up to 50 years
Alternative 5: Negotiated Rulemaking – The components of this alternative are unknown at this time.				

RESPONSE TO THE TWELVE (12) CRITERIA	Alternative 1: Current Policy	Alternative 2: 2009 Phase-in Set Growth	Alternative 3: 2003 Set Growth	Alternative 4: Joint Venture
1) Results in revenue equal to or greater than 2009 revenue?	Yes	Yes	Yes	Yes
2) Lowers the future or predicted lease rent from status quo?	No	Yes	Yes	Yes
3) Provides a lease rate lower than 5%?	No	Yes	Yes; lower than 5% of 2009 DOR value	Yes
4) Provides a predictable lease rent?	No	Yes; escalate annually; value review every 15 years with caps	Same as Alternative 2	Yes; base lease rent is predictable
5) Increases the lease	No	Yes	Yes	Yes

RESPONSE TO THE TWELVE (12) CRITERIA	Alternative 1: Current Policy	Alternative 2: 2009 Phase-in Set Growth	Alternative 3: 2003 Set Growth	Alternative 4: Joint Venture
term to provide for lending?				
6) Lowers 2009 DOR appraised value?	No, assumes 2009 DOR value	No, assumes 2009 DOR value	Yes, uses 2003 DOR value, adjust yearly	Yes, uses 2003 DOR value
7) Provides full market value for the beneficiaries?	Yes	Yes; Lease rate above 3.5% threshold	Yes; Lease rate 5% of adjusted 2009 value	Yes; see financial analysis
8) Eliminates the “A-E” cycles?	No	Yes	Yes	Yes
9) Provides a cap to help mitigate increases and decreases?	No	Yes	Yes	Yes; rate restricted to 3.6% to 5%
10) Clarifies lease administration for both DNRC and lessees?	No	Yes	Yes	Yes
11) Provides consideration for “low-income” residents?	No	Yes; rent freeze for qualifying lessees for limited time.	Same as Alternative 2	Yes; proposes rent reduction.
12) Modifies the improvements management policy as recommended in the report?	No	Yes; extends time for marketing; provides for lessee maintenance of improvements	Same as Alternative 2	Same as Alternative 2
Alternative 5: Negotiated Rulemaking – How this alternative responds to the 12 criteria is unknown at this time.				